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IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1973**

No. 73-263

COMMISSIONER OF INTERNAL REVENUE,
*Petitioner,*

*v.*

IDAHO POWER COMPANY,
*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

## BRIEF FOR THE RESPONDENT

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## BRIEF FOR THE RESPONDENT

### Question Presented

Whether depreciation on equipment owned and used in part by a taxpayer in constructing its capital facilities may be deducted over the lives of the equipment or must be capitalized as part of the adjusted basis of the facilities constructed?

### Statement of the Case

The statement of the facts in the government's brief in this case omits the following relevant facts:

1. The transportation equipment, the depreciation of which is in issue here, was used by the taxpayer

not merely for construction but also in operations and maintenance (Stip. ¶ 6, App. 12)[1].

2. This equipment was depreciated for tax purposes over a composite life of ten years (Stip. ¶ 7, App. 12) and the facilities which such equipment was in part used to construct had useful lives of 30 years or longer (Stip. ¶ 9, App. 13).

3. For tax purposes, to the extent transportation equipment was used in the construction of capital assets taxpayer capitalized all costs of operating and maintaining such equipment, except pension contributions, social security taxes, motor vehicle taxes and depreciation. The government and taxpayer are in agreement that it was proper for taxpayer to deduct currently the pension contributions, social security taxes and motor vehicle taxes (Stip. ¶ 14, App. 19).

## Summary of Argument

The taxpayer used its own mobile equipment having a 10 year life, including trucks and specialized equipment, in part for operations and maintenance and in part for the self-construction of facilities having lives in excess of 30 years. The question is whether for federal income tax purposes the taxpayer may deduct depreciation on the equipment over its 10 year life or must capitalize an allocable portion of the depreciation as part of the adjusted basis of the facilities constructed thereby requiring that the deduction for depreciation be spread over a period of more than 40 years which includes the useful lives of both the equipment and the facilities constructed.

This question is to be resolved by the intention of Congress in enacting sections 167 and 263 of the Internal Reve-

1. App. refers to the Joint Appendix provided for under Rules 35 and 36.

nue Code and their statutory predecessors. Under section 167 a taxpayer is allowed as a depreciation deduction an allowance for the "exhaustion, wear and tear . . . of property used in the trade or business". It is conceded that taxpayer's equipment is depreciable and, there is no issue in the instant case as to whether depreciation on such equipment is an allowable deduction under section 167 unless this deduction is precluded by reason of another provision in the Internal Revenue Code.

Historically section 263 of the Internal Revenue Code has disallowed deductions for "[a]ny amount paid out for new buildings or for permanent improvements or betterments" which language was first adopted as part of a Civil War income tax act. In 1951, the word "expenditures" was added as the equivalent of "amount paid out". When the basic provision of section 263 was first enacted in 1864 it was clearly not intended by Congress to disallow a deduction for depreciation as the concept of depreciation had not yet been recognized in the United States. When this language was used by Congress in the Tariff Act of 1909 and in the Tariff Act of 1913, the predecessors of the present Internal Revenue Code, Congress manifested an understanding that the deduction for depreciation was the equivalent of a loss or reduction in the value of property as used rather than an amount paid out. This understanding of Congress as to the nature of depreciation has continued up to the present time and has been recognized in court decisions and in Treasury Regulations.

In light of the understanding of Congress that depreciation is a reduction in value of property, throughout the history of the Internal Revenue Code whenever Congress has had occasion in a particular section of the Code to treat depreciation as being the equivalent of an amount paid or expenditure it has expressly so provided. This

treatment has been uniformly followed in the case of the deduction for depreciation but has not been applied in the case of any other deduction. For example, in sections 174, 182, 615, 616 and 617 in which taxpayers are given the right to elect under various circumstances to deduct or capitalize expenditures, Congress has in each case provided that "allowances for depreciation shall be considered, for purposes of this section, as expenditures paid or incurred" or equivalent language. On the other hand, when Congress has not intended depreciation to be treated as a payment or amount paid, as in section 170 concerning charitable contributions and section 213 concerning deduction of medical expenses, it has included no comparable provision. Congress has never provided that depreciation shall be considered an amount paid or an expenditure in section 263. In light of the care Congress has taken throughout the Internal Revenue Code to define or designate depreciation as an expenditure when it is intended to be treated as such, it is apparent that Congress has continued the intention of previous Congresses which first enacted the statutory predecessors of section 263 that depreciation should not be considered an amount paid out or an expenditure under this section.

That Congress has not provided that the terms amount paid or expenditure shall include depreciation in section 263 and, as a consequence, has not required the capitalization of depreciation on equipment used by the taxpayer to construct its facilities, is consistent with the Congressional intent concerning the deduction for depreciation. The basic purpose of Congress in allowing such deduction has been to permit a taxpayer to recover free of tax its investment in capital equipment over the life of such equipment in order that the taxpayer will have available funds to replace it. Congress recognized American business must replace

equipment with modern higher cost equipment to maintain its efficiency and compete with businesses throughout the world and has placed increased emphasis upon the concept of tax-free recovery of cost. This was reflected in 1954 when Congress enacted the Internal Revenue Code of 1954 which permitted taxpayers to use accelerated methods of depreciation under which a taxpayer could recover 40 percent of the cost of an asset in the first quarter of its useful life and two-thirds of the cost in the first half of its life. This increased emphasis on cost recovery was further highlighted when Congress provided at section 167(m) of the Code for the class life method of depreciation under which useful lives were to be established on the basis of shorter lives than the average lives claimed by taxpayers and taxpayers were permitted to reduce these shorter lives by 20 percent.

The importance of permitting the taxpayer to recover free of tax its cost of capital equipment is equally applicable to equipment used by the taxpayer to construct its own facilities. It is just as important for a taxpayer who uses equipment in self-construction to be permitted tax-free recovery of the cost of such equipment over its life in order that it may be replaced with modern equipment as it is for taxpayers who use equipment for maintenance or production. In this respect equipment used in self-construction of facilities differs from expenditures for labor, materials and similar expenditures that become part of the facilities for these expenditures need not be replaced until the end of the useful lives of the facilities and their cost may be recovered over such lives.

The government urges that under section 161 the deduction for depreciation is subordinate to section 263. However, section 161 is merely a housekeeping section which provides that the deductions allowed under sections 162

through 188 are subject to the exceptions provided at sections 261 through 279. In adopting section 161 in 1954 Congress neither limited its intention concerning the scope of the deductions in sections 162 through 188 nor expanded its intention concerning the scope of the exceptions provided in sections 261 through 279.

The government argues that depreciation on taxpayer's equipment should be capitalized under the financial accounting concept of matching expenses with income. However, tax accounting for depreciation is not based on the concept of matching expense with income. It has long been held that depreciation must be deducted in the year in which it is properly incurred regardless of whether it contributes to the production of income in such year and regardless whether the depreciable equipment was in use or idle in such year. In its emphasis on the deduction for depreciation as a means for tax-free recovery of cost over the early portion of the life of the property in order to provide taxpayer with funds to replace and modernize equipment, Congress has clearly indicated its understanding that cost-recovery rather than matching deductions against income is the controlling principle in allowing depreciation.

The government also urges that under financial concepts of cost the depreciation of equipment used in the self-construction of facilities should be capitalized as a part of the cost thereof. Cost is nowhere defined in the Internal Revenue Code or Treasury Regulations. However, it is clear that general financial or economic concepts of cost are not controlling for tax purposes. For example, interest and state and local taxes incurred in connection with the construction of capital assets have never been required to be capitalized even though economically they represent a part of the cost of self-constructed facilities. The government has expressly recognized this principle in the instant case

by allowing taxpayer to deduct social security taxes, motor vehicle taxes and pension contributions incurred in connection with the construction of its facilities. The provisions of the Internal Revenue Code, and not general concepts of cost, govern the allowance of depreciation.

Depreciation on taxpayer's equipment used in the self-construction of facilities is an allowable deduction under section 167 and is not subject to the exception provided at section 263. This depreciation should be allowed under the express statutory provisions of the Internal Revenue Code in accordance with the intention of Congress.

## Argument

### I.

**Sections 167 and 263 of the Internal Revenue Code rather than financial concepts of accounting or cost determine whether depreciation on equipment owned by a taxpayer and used in part to construct its facilities is to be deducted over the useful life of the equipment or capitalized.**

#### A. Financial accounting concepts do not reflect the practical treatment by Congress of depreciation as a means of recovering cost.

The taxpayer used various types of equipment such as passenger cars, specially equipped trucks, cranes and backhoes in part for operations, in part for maintenance and in part for construction of facilities. Taxpayer deducted depreciation on this equipment over its useful life of 10 years. To the extent that the equipment is used in construction of facilities the government would require that

depreciation be deducted over the period of 10 years plus the useful lives of 30 or more years of the facilities constructed or a total of at least 40 years.[2]

Both the government and the taxpayer are in agreement that section 167 of the Internal Revenue Code would permit the taxpayer to deduct depreciation over the 10 year life of the equipment if it were not used in construction (Pet. Br. 9).[3] The sole issue in dispute is whether section 263 by its terms requires capitalization of depreciation where the taxpayer uses its own equipment to construct its facilities.

As support for its view that such depreciation must be capitalized, the government asserts that matching the deduction of depreciation against the production of income is the basic principle controlling the timing of such deduction and that to achieve this purpose the deduction should be deferred until long after the equipment is no longer in existence (Pet. Br. 9).

However, the legislative history of the federal income tax laws indicates that the primary purpose of Congress has been to provide through the deduction for depreciation a "method by which the capital invested in an asset is recovered tax-free over the years it is used in a business." H. Rep. No. 1337, 83d Cong., 2d Sess., 22; see also *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960); *United States* v. *Ludey*, 274 U.S. 295, 300 (1927). The taxpayer must have funds to replace his equipment with new and efficient equipment when its useful life terminates.

2. Depreciation applicable to the last year in which the equipment is used in construction would be deducted in the last year in which the constructed facilities are depreciated.

3. Pet. Br. refers to the Brief for the Petitioner.

There has never been a requirement that the deduction for depreciation must match the production of income.[4] Moreover, in the legislative history of section 167, Congress has placed increased emphasis on its purpose of providing for recovery of cost of capital equipment and has over the years given little credence to any concept of matching the deduction for depreciation against income.

The tax-free recovery of the cost of a capital asset has been accomplished by Congress through the allowance of depreciation without limitation over the useful life of property used in business by section 167 and its statutory predecessors. Section 263 of the Internal Revenue Code and its statutory predecessors which set forth the requirements for capitalization would conflict with this concept of cost recovery only if they required capitalization of depreciation and they have not so required.

The concept adopted by Congress of deduction of depreciation as a means of tax-free recovery of capital investment is equally applicable to taxpayer's equipment used to construct its facilities. The equipment itself represents a capital investment that is being consumed as the equipment is used and the taxpayer must acquire funds over the equipment's useful life to replace it. Depreciation on such equipment differs from expenditures for labor, materials, etc., that become part of the cost of the facilities constructed

4. Depreciation must be deducted in the year it is properly deductible over the life of the depreciable property regardless of whether it contributes to the production of income in such year. See *Virginian Hotel Corporation* v. *Helvering*, 319 U.S. 523 (1943). Once depreciable property is devoted to a taxpayer's business, depreciation is an allowable deduction (and must be used to reduce the property's basis) regardless of whether or not the property is used to produce income in the taxable year or is idle and not used for any purpose. *Sears Oil Co., Inc.* v. *Commissioner*, 359 F.2d 191 (2nd Cir., 1966); *P. Dougherty Company* v. *Commissioner*, 159 F.2d 269 (4th Cir., 1946), certiorari denied, 331 U.S. 838 (1947); *Kittredge* v. *Commissioner*, 88 F.2d 632 (2nd Cir., 1937).

and need not be replaced until the end of the useful lives of these facilities. Their costs may properly be recovered by depreciation over the lives of such facilities.

The government urges that proper financial accounting requires that the deduction for depreciation be matched with the production of income citing such authorities as Paton, *Asset Accounting: An Intermediate Course,* 192-193 (1st ed., 1952), and Finney & Miller, *Principles of Accounting-Introductory,* 246-247 (6th ed., 1963), and argues that proper tax accounting in this situation accords with financial accounting (Pet. Br. 11-15).

However, the authors cited by the government, as well as numerous other writers on the principles of financial accounting, have pointed out that a simple allocation of depreciation based on historical cost over the useful life of equipment to match depreciation expense against income does not result in an accurate reflection of income for the reason that the owner must ordinarily replace the equipment at a higher cost. An additional expense is being incurred which is not reflected in the accounting statements. See and compare: Paton, *Asset Accounting: An Intermediate Course,* 313-314, 328-332 (1st ed., 1952); Finney & Miller, *Principles of Accounting—Intermediate,* 539-541 (6th ed., 1965); Simons, *Intermediate Accounting,* 527-529, 1016-1019 (5th ed., 1972); Meigs, Johnson, Keller and Mosich, *Intermediate Accounting,* 417-420 (2nd ed., 1968); Sprouse and Moonitz, *A Tentative Set of Broad Accounting Principles for Business Enterprises,* Accounting Research Study No. 3, 15-17, 32-34 (1962); Committee on Concepts and Standards—Long-Lived Assets, American Accounting Association, "Accounting for Land, Buildings and Equipment—Supplementary Statement No. 1", *The Accounting Review,* vol. XXXIX, No. 3, 693, 695-696 (1964). It has also been pointed out that different objec-

tives control the principles of tax accounting which as a consequence does not follow financial accounting. Finney & Miller, *Principles of Accounting—Introductory*, 562 (7th ed., 1970); Meigs, *supra*, 389, 638.

In its continuing attention to depreciation as a means of tax-free cost recovery Congress has recognized that in the taxation of income this presents a practical rather than a theoretical problem. If not resolved business will not be able to retain funds after tax to replace its capital equipment with efficient equipment and acquire additional equipment required for economic growth.

The problem of providing after-tax funds for replacement and improvement of capital facilities has two aspects. The first is that the historical cost of the equipment should be recovered without being subjected to tax. The second is that recovery of historical cost alone is not sufficient. If American business is to maintain its efficiency and to compete with business throughout the world, it must ordinarily replace equipment with improved and higher cost equipment and modernize and expand its capital facilities.

There are various possibilities for resolving the problems of replacing equipment at higher cost including allowing depreciation based on current cost or replacement cost coupled with various indices and other factors. See and compare: Paton, *Asset Accounting: An Intermediate Course*, 333-357 (1st ed., 1952); Simons, *Intermediate Accounting*, 1016-1053 (5th ed., 1972); Meigs, Johnson, Keller and Mosich, *Intermediate Accounting*, 420-424 (2nd ed., 1968).

However, Congress has not adopted these approaches suggested by accountants, but has instead adopted the principle of permitting recovery of historical cost through deductions for depreciation in the early portion of the equipment's useful life so that the funds retained after tax

together with earnings on such funds generated by their use in the taxpayer's business or by investment will permit the replacement of equipment at higher cost. Adoption of this concept is evident from the provisions of the Internal Revenue Code concerning the timing of the deduction for depreciation and explanatory reports of Congressional committees.

In section 167 of the Internal Revenue Code of 1954, Congress enacted specific provisions for the timing of depreciation deductions and allowed the use of the declining balance method at twice straight line depreciation rates and the sum of the years-digits method for computing depreciation. These methods permit the tax-free recovery of cost in the early portion of the life of equipment so that the taxpayer may, through use of the funds recovered in his own business, replace the equipment at a higher cost or acquire other modern facilities. For example, the declining balance method at twice straight line rates permits the deduction of approximately 40 percent of the cost of an asset in the first quarter of its useful life and two-thirds of the cost in the first half of its life. H. Rep. No. 1337, 83d Cong., 2d Sess., 23. The purpose of Congress was explained in the Report of the Committee on Ways and Means which contains the following statement:

> "There is evidence that the present system of depreciation acts as a barrier to investment, particularly with respect to risky commitments in fixed assets. Comparatively slow rates of write-off tend to discourage replacement of obsolete equipment and the installation of modern, up-to-date machinery. Under long-run peacetime conditions, in the absence of the inflationary pressures existing in the forced-draft economy of the postwar period, present tax depreciation methods might depress business capital expenditures below the level needed to keep the

economy operating at high levels of output and employment."

• • •

"More liberal depreciation allowances are anticipated to have far reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living."[5] (H. Rep. No. 1337, 83d Cong., 2d Sess., 22-24.)

Subsequently, in 1971 Congress amended the Internal Revenue Code to implement further its intention to utilize accelerated nontaxable cost recovery as a means of pro-

5. The importance of the rapid tax-free recovery of costs as a means of enabling United States industry to compete on the international level was recognized in the following statement:

"Various forms of faster write-off of fixed assets have been almost universally adopted in recent years by countries with modern income tax systems. Among such countries are Great Britain, Canada, and Sweden. The results of the liberalized depreciation policies have generally been favorable in stimulating plant modernization and expansion. While comparisons are difficult, the proposals contained in your committee's bill do not go as far in the direction of accelerated depreciation as the treatment in some other countries nor as far as some of the proposals which have been brought to your committee's attention. Mindful of the need for constructive action within the limits of sound budgetary policy, your committee has adopted provisions which will give the economy added stimulus and resilience without departing from realistic standards of depreciation accounting." (H. Rep. No. 1377, 83d Cong., 2d Sess., 24.)

viding funds for the replacement and improvement of equipment at higher cost. This is reflected in the enactment of section 167(m) of the Code pursuant to which Congress anticipated that lives for assets would be established by the Department of the Treasury on the basis of lives previously recognized in Guidelines for Depreciation, Revenue Procedure 62-21, 1962-2 C.B. 418. These lives were generally equal to the lives being claimed by taxpayers at the 30th percentile, i.e., 29 percent of the assets had shorter lives and 70 percent had longer lives. H. Rep. No. 92-533, 92d Cong., 1st Sess., 30; S. Rep. No. 92-437, 92d Cong., 1st Sess., 46. Further, in section 167(m) it was provided that taxpayers are permitted to use lives of up to 20 percent less than the lives so established.

The result of these provisions of the Internal Revenue Code concerning the timing of depreciation is that taxpayers are permitted to apply the double declining balance and sum of the years-digits methods of depreciation to useful lives reflecting the 30th percentile of actual lives previously used further reduced by 20 percent. Congress has effectively applied its concept of depreciation as a means of providing a tax-free recovery of cost so that taxpayers can replace equipment when no longer useful in their businesses, often at high costs, with modern equipment.

Therefore, Congress in implementing its historical concept of depreciation as a means of tax-free recovery of cost has not followed the concept of financial accounting that the deduction for depreciation should match the generation of income as urged by the government in this case. To carry out the intention of Congress, tax accounting reflects the deduction of depreciation in the early portion of the asset's life to provide for the tax-free recovery of cost so that equipment may be replaced at the end of its useful life

with efficient and more costly equipment and funds will be available for modernization. The correlation of the deduction of depreciation with the production of income is not an accounting principle which justifies the capitalization of depreciation on equipment used by the taxpayer to construct its facilities.

This Court has recognized that a departure from the financial accounting concept of matching expenses with income is appropriate in determining taxable income where required by statute or to carry out the intention of Congress. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Association* v. *United States*, 367 U.S. 687 (1961); *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957). Under the tax law expenses also may be deducted prior to the year in which the related income is realized. *Breeze Corporations, Inc.* v. *United States*, 117 F. Supp. 404 (Ct. Cl., 1954); *Patchen* v. *Commissioner*, 27 T.C. 592 (1956), A. 1957-2 C.B. 6, affirmed and reversed on other issues, 258 F.2d 544 (5th Cir., 1958); *Globe Corporation* v. *Commissioner*, 20 T.C. 299 (1953), A. 1953-2 C.B. 4; *Foster Wheeler Corporation* v. *Commissioner*, 20 T.C. 15 (1953), A. 1953-2 C.B. 4.

The government, applying the concept that depreciation, as distinguished from other types of deduction, must be matched against income, argues that the taxpayer should not be permitted to deduct depreciation over the 10 year life of its equipment, but instead should capitalize such depreciation and thereby spread it over a more than 40 year period which includes both the lives of the equipment and the self-constructed facilities. Such an argument is in direct conflict with the long recognized concept of Congress that depreciation is a method of tax-free recovery of capital investment which has been adopted to provide accelerated recovery in order to make available funds for higher cost replacement and for modernization.

Equipment used in self-construction by taxpayer represents a capital investment which like all other capital investments must be recouped if the equipment is to be replaced at the end of its useful life. It differs from expenditures such as direct labor and materials which need not be recovered until the constructed facilities must be replaced. It is as important to the economy and to the taxpayer that it be permitted to replace construction equipment with other equipment which is more efficient and costly at the termination of its life as it is to accumulate funds for the replacement of any other capital asset. The deduction for depreciation on taxpayer's equipment should not be disallowed under a financial accounting concept which is at variance with the Congressional purpose of cost recovery.

**B. Financial concepts of cost do not accord with the provisions of the Internal Revenue Code.**

The government urges that depreciation on equipment used by the taxpayer to self-construct facilities is part of the financial or economic cost of such facilities and should therefore be capitalized (Pet. Br. 10-11).

The term "cost" is nowhere defined in the Internal Revenue Code or even in the Treasury Regulations. At section 1012 of the Code it is provided that "[t]he basis of property shall be the cost of such property"; in the Treasury Regulations at 26 C.F.R. 1.263(a)-1 it is provided that "no deduction shall be allowed for—(1) [a]ny amount paid out for new buildings or for permanent improvements or betterments . . ." and 26 C.F.R. 1.263(a)-2(a) includes as an example of capital expenditures "[t]he cost of acquisition, construction, or erection of buildings, machinery and equipment. . . ."[6] Read in their entirety, the Regu-

6. It is not stated or implied in the example that cost includes depreciation on equipment used by a taxpayer in self-construction.

lations interpreting section 263 of the Code necessarily imply that the cost of self-contructed facilities is the amount that must be capitalized under section 263. If section 263 does not require the capitalization of depreciation on equipment used in the self-construction of capital assets, the regulations do not convert such depreciation into a cost.

However, the government asserts that, on the basis of accounting and economic principles, depreciation on equipment used by the taxpayer to construct its facilities is part of the cost of such facilities and since it is cost it must be capitalized (Pet. Br. 10-11). This approach would resolve the question at issue without proper consideration of the applicable provisions of the Internal Revenue Code concerning depreciation and capitalization. It assumes the conclusion and reasons backwards.[7]

The problem is not one of general concepts of cost. For example, one possible definition of the cost of self-constructed property would be that there should be included in cost all amounts that contribute to the value of the property. In substance this would include all amounts that must

7. This same fundamental error was made by the Tax Court in this case and in varying degrees in the cases cited by the government as requiring capitalization of depreciation (Pet. Br. 22): *Coors* v. *Commissioner*, 60 T.C. 368 (1973); *Southern Natural Gas Co.* v. *United States*, 412 F.2d 1222 (Ct. Cl., 1969); *Producers Chemical Co.* v. *Commissioner*, 50 T.C. 940 (1968), A. 1969-1 C.B. 21; *Brooks* v. *Commissioner*, 50 T.C. 927 (1968), reversed on other grounds, 424 F.2d 116 (5th Cir., 1970); *Missouri Pacific R. Co.* v. *Commissioner*, 22 B.T.A. 267 (1931), A. and NA., X-2 C.B. 48, 95 (1930); *Gulf, M. & N.R. Co.* v. *Commissioner*, 22 B.T.A. 233 (1931), NA., XI-2 C.B. 13 (1932), affirmed on other issues, 71 F.2d 953 (D.C. Cir., 1934), affirmed on other issues, 293 U.S. 295 (1934); *Chicago, R.I. & P. Ry. Co.* v. *Commissioner*, 13 B.T.A. 988 (1928), reversed as to other issues, 47 F.2d 990 (7th Cir., 1931), certiorari denied, 284 U.S. 618 (1931); *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225 (1927), A. and NA., VII-2 C.B. 16, 47 (1928), affirmed, 40 F.2d 372 (8th Cir., 1930), certiorari denied, 282 U.S. 855 (1930).

be recovered by a third party if he had constructed the property. It would include among other elements, direct labor and materials, interest expense, state and local taxes, federal income tax and profit. However, as more fully discussed below, interest expense and state and local taxes have never been treated under the Internal Revenue Code as part of the cost of a self-constructed facility and the elements of federal income tax and profit would not be incurred or realized by a taxpayer constructing its own facilities.

A possible alternative would be to define cost as including all of those amounts which the taxpayer who constructed his own facilities would not have incurred but for such construction. Again this would include direct labor, materials, interest expense and state and local taxes even though the last two items have never been included in the cost of self-constructed facilities.

The provisions of the Internal Revenue Code rather than economic or accounting concepts are controlling for the purpose of ascertaining the basis of self-constructed facilities for federal income tax purposes. In the instant case the government has recognized this by not disallowing taxpayer's deductions for pension contributions, social security taxes and motor vehicle taxes attributable to the construction activities. The government concedes the correctness of these deductions (Stip. ¶14, App. 19) notwithstanding the fact that under economic or financial accounting standards these items would be part of the cost of self-constructed facilities.[8]

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8. Social security taxes and motor vehicle taxes were allowed as a deduction under Internal Revenue Code section 164. Pension contributions were allowed as a deduction under a long standing interpretation of the predecessor of section 404 in I.T. 3408, 1940-2 C.B. 178.

Even though Internal Revenue Code section 263, or a statutory predecessor, has been included in the applicable tax law since the beginning of present federal income tax laws in 1913, interest and state and local taxes, which would not have been incurred by a taxpayer but for his construction activities, have always been deductible by a taxpayer under sections 163 and 164 of the Internal Revenue Code and their statutory predecessors. Prior to the adoption of the statutory predecessor of section 266 of the Internal Revenue Code in section 130(a) of the Revenue Act of 1942,[9] no election could be made to capitalize these expenditures, *Southern Ry. Co.* v. *Commissioner*, 27 B.T.A. 673, 682-684 (1933), A. and NA., XII-2 C.B. 13, 25 (1933), affirmed and reversed on other issues, 74 F.2d 887 (4th Cir., 1935); *Spring Valley Water Co.* v. *Commissioner*, 5 B.T.A. 660, 662-663 (1926); and since that time they can be capitalized only if an election to do so has been made. *Stout* v. *Commissioner*, 31 T.C. 1199, 1211-1214 (1959), A. 1959-2 C.B. 7, affirmed and modified on other issues *sub nom.*, *Rogers* v. *Commissioner*, 281 F.2d 233 (4th Cir., 1960); *Kentucky Utilities Company* v. *Glenn*, 394 F.2d 631, 635 (6th Cir., 1968); *Smyth* v. *Sullivan*, 227 F.2d 12, 13-14 (9th Cir., 1955); Revenue Ruling 70-539, 1970-2 C.B. 70, 71.

This interpretation was analogous to the interpretation that prevented the capitalization of interest, taxes and carrying charges on unimproved and unproductive real property prior to the time when such capitalization was permitted by section 113(b)(1)(A) of the Revenue Act of 1932.[10] *Queensboro Corporation* v. *Commissioner*, 134

9. Revenue Act of 1942, ch. 619, 56 Stat. 798, 827.

10. Revenue Act of 1932, ch. 209, 47 Stat. 169, 201, subsequently superseded by sections 130(a) and 130(b) of the Revenue Act of 1942, ch. 619, 56 Stat. 798, 827.

F.2d 942, 944 (2nd Cir., 1943); *H.M.O. Lumber Co.* v. *United States*, 59 F.2d 907, 908-909 (6th Cir., 1932); *Central Real Estate Co.* v. *Commissioner*, 47 F.2d 1036, 1038 (5th Cir., 1931); *Westerfield* v. *Rafferty*, 4 F.2d 590, 593-594 (E.D.N.Y., 1925); *Appeal of Pacific Coast Redwood Co.*, 5 B.T.A. 423, 427 (1926), A. VI-2 C.B. 5 (1927).

The specific provisions of the Internal Revenue Code determine whether or not amounts must be capitalized, regardless of whether a taxpayer is required by a regulatory agency to capitalize such amounts on its books of account. Specifically, it has long been recognized that interest during construction, which was capitalized on a taxpayer's books of account in accordance with regulatory requirements, was nevertheless deductible for tax purposes and could not be added to the basis of constructed assets prior to the enactment of the statutory predecessors of section 266. *Southern Ry. Co.* v. *Commissioner*, 27 B.T.A. 673, 682-684 (1933), A. and NA., XII-2 C.B. 13, 25 (1933), affirmed and reversed on other issues, 74 F.2d 887 (4th Cir., 1935); *Spring Valley Water Co.* v. *Commissioner*, 5 B.T.A. 660, 662-663 (1926). The accounting requirements of regulatory agencies are not controlling for tax purposes. *Old Colony Railway Company* v. *Commissioner*, 284 U.S. 552, 562 (1931); *Mine Hill & Schuylkill Haven Railroad Company* v. *Smith*, 184 F.2d 422, 426 (3rd Cir., 1950), certiorari denied, 340 U.S. 932 (1951). The Internal Revenue Service has also recognized that interest during construction may be currently deducted notwithstanding the fact that the taxpayer is required to capitalize such interest on its books of account. Revenue Ruling 70-88, 1970-1 C.B. 32.

The fact that throughout the history of the federal income tax law, it has been interpreted to permit deductions of certain types of expenditures incurred by a tax-

payer in constructing its own facilities regardless of the existence of the statutory predecessors of section 263 necessarily indicates that the question of whether depreciation on equipment used in such construction must be capitalized may not be resolved by financial accounting concepts but instead turns on the intention of Congress as manifested in the provisions of the statute. The concepts adopted by Congress in enacting federal income tax laws are those appropriate for taxation and do not necessarily follow economic or financial principles. *Helvering* v. *Midland Mutual Life Insurance Co.*, 300 U.S. 216, 225 (1937); *Weiss* v. *Wiener*, 279 U.S. 333, 335 (1929).

This principle, that the provisions of the Internal Revenue Code are controlling, has been accepted by the government in the discussion in its brief of the decision in *All-Steel Equipment Inc.* v. *Commissioner*, 54 T.C. 1749 (1970), reversed in part, 467 F.2d 1184 (7th Cir., 1972) (Pet. Br. 17-18). However, the government is in error in its interpretation of the application of the principle to section 161.[11] The case concerned the question of whether deductions for taxes, losses and research and experimental expenditures could be deducted under sections 164, 165 and 174 of the Internal Revenue Code or must be included in inventory which is in effect a form of capitalization. The Tax Court held that these items were properly deductible. The government agrees with the conclusion of the Tax Court but disagrees with its analysis, urging that under section 161 of the Internal Revenue Code, deductions allowed by sections 162 through 188 are subordinate to sections 261 through 279 (Pet. Br. 18). However, section 161 does not make the

11. The government is also incorrect in its interpretation of the decision of the Court of Appeals in the present case. The basic decision of that court was that depreciation on property used in business is deductible under section 167 and section 263 does not disallow such deduction by requiring the capitalization of any "amount paid". (477 F.2d at 693-695; Pet. App. 30-32)

former group of sections subordinate to the latter in the sense implied by the government. Section 161 is a housekeeping section that merely makes the former group of sections "subject to the exceptions" of the latter group. Section 161 neither reduced the scope of the deductions in the former group nor increased the exceptions in the latter. For example the government agreed that the Tax Court was correct in *All-Steel Equipment* in not requiring the capitalization of a loss deductible under section 165 although the government could find no provision in sections 261 through 279 that specifically excepted losses from capitalization. The reason is that Congress did not intend that losses should be capitalized and included no language in section 263 or any other section that would require capitalization.

Just so in the instant case, section 167 allows a deduction for depreciation and there is no language in section 263 or any other section that requires capitalization. This issue must be resolved by application of the provisions of the Internal Revenue Code.

### C. Sections 167 and 263 of the Internal Revenue Code are exclusively applicable.

The statutory provisions of the Internal Revenue Code control in determining whether depreciation on equipment used in self-construction may be deducted. *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 682 (1962); *Lewyt* v. *Commissioner*, 349 U.S. 237, 240 (1955); *Commissioner* v. *Korell*, 339 U.S. 619, 625-626 (1950).

Section 161 of the Internal Revenue Code provides that the deductions for individuals and corporations set forth at sections 162 through 188 shall be allowed "subject to the exceptions" provided in sections 261 through 279. Section 167 provides without limitation for a deduction for depre-

ciation on property used by a taxpayer in his trade or business. Section 263 concerning capitalization would limit the deduction for depreciation under section 167 only if it were intended by Congress to be an exception to such deduction. These two sections which are specifically applicable in determining whether depreciation on equipment used in self-construction is deductible prevail over all general provisions of the Code including the provisions concerning methods of accounting. *Spring City Foundry Company* v. *Commissioner*, 292 U.S. 182, 189 (1934); *Central Commercial Company* v. *Commissioner*, 337 F.2d 387, 389 (7th Cir., 1964); *Essenfeld* v. *Commissioner*, 311 F.2d 208, 209-210 (2nd Cir., 1963); *Service Life Insurance Company* v. *United States*, 293 F.2d 72, 77 (8th Cir., 1961).

## II.

**Section 167 allows the deduction of depreciation on equipment used in part by the taxpayer to construct its facilities.**

For at least 40 years taxpayer has regularly engaged in the construction of additions to its own business properties, such as facilities for the transmission and distribution of electric energy. This construction has been substantial. The cost of facilities constructed by taxpayer amounted to more than $12,000,000 in 1962 and 1963, the years at issue.

Passenger cars, various types of trucks and power operated trailers were used in part for this construction and in part for operations and maintenance. Communication equipment was affixed to some items of this equipment. It is the portion of depreciation on this equipment which is attributable to construction activities which is at issue in the instant case.

Section 167 provides for a depreciation deduction with respect to property "used in the [taxpayer's] trade or business" or "held for the production of income [by the taxpayer]". The government has not asserted that the equipment was not used in taxpayer's trade or business to the extent it was used for operations and maintenance. However, in the Tax Court and the Court of Appeals the government argued that the equipment, to the extent it was used in constructing facilities, was not used in taxpayer's trade or business. While the Tax Court reached no decision on this issue, the Court of Appeals expressly found that the equipment was used in taxpayer's trade or business. In this Court the government apparently has abandoned this argument and concedes that the equipment, even when used in construction activities, is used in the taxpayer's trade or business (Pet. Br. 9). There is no longer any issue as to whether depreciation is allowable under section 167 and the only remaining issue is whether section 263 requires capitalization of this depreciation.

The government is correct in conceding that the equipment used to construct taxpayer's facilities was used in taxpayer's trade or business. The taxpayer was engaged in trade or business at the time the facilities were constructed. For more than 40 years taxpayer has constructed facilities while the taxpayer was at all times engaged in the transmission, generation and distribution of electric energy.

The courts have held that a taxpayer's trade or business includes all activities in furtherance of, or incidental to, the taxpayer's principal business. There is no requirement that a particular portion of a taxpayer's business activities be carried on to earn a profit or income separable from that derived from its principal business. For example, in *Corn Products Refining Company* v. *Commissioner*, 350 U.S. 46 (1955), the taxpayer, a manufacturer of products from

grain corn, purchased and sold corn futures to protect itself against price increases in corn and to assure itself of a supply of corn. It was held that gain and loss on the sale of corn futures was ordinary rather than capital as occurring in the ordinary course of the taxpayer's business.

The same principle has been applied in a variety of situations. Where taxpayer purchased stock in order to acquire an inventory or supply of materials for his business, a loss on the stock is realized in the ordinary course of his trade or business and treated as ordinary rather than capital. *Grier Co.* v. *United States,* 328 F.2d 163 (7th Cir., 1964); *Edwards* v. *Hogg,* 214 F.2d 640 (5th Cir., 1954); *The Journal Company* v. *United States,* 195 F. Supp. 434 (E.D. Wisc., 1961); *Smith and Welton Incorporated* v. *United States,* 164 F. Supp. 605 (E.D. Va., 1958). It has been decided that player contracts held by a corporation operating a professional baseball team are held primarily for sale to customers in the ordinary course of the taxpayer's business so that a gain or loss on the sale of such contracts is ordinary. *Hollywood Baseball Association* v. *Commissioner,* 423 F.2d 494 (9th Cir., 1970), certiorari denied, 400 U.S. 848 (1970). Real estate parcels acquired by an insurance company by mortgage foreclosures and thereafter rented for an extended period of time were held in the taxpayer's trade or business so that losses on sales of the property were ordinary. *Workmen's Mutual Fire Insurance Society, Inc.* v. *A'Hearn,* 286 F.2d 718 (2nd Cir., 1961).

Treasury Regulations applicable to the investment credit provide that where a taxpayer uses his equipment for self-construction of facilities, the equipment is depreciable. The investment credit is allowed at section 38 of the Internal Revenue Code for property qualifying at section 48. Under the latter section the investment credit is limited to property "with respect to which depreciation (or amortization

in lieu of depreciation) is allowable". The Regulations provide that the investment credit is allowed on the equipment used in self-construction, 26 C.F.R. 1.46-3(c)(1) and 1.48-1(b)(4), thereby treating such property as being used in the taxpayer's trade or business.[12]

The acquiring of facilities is part of taxpayer's trade or business of production, transmission and sale of electric energy. The scope of such trade or business includes the acquisition of facilities not only by purchase but also by self-construction.

## III.

**Congress did not intend that section 263 should require capitalization of depreciation on equipment used by a taxpayer in part to construct its facilities.**

As a guide to the interpretation of the intention of Congress the government has stated that section 161 of the Internal Revenue Code indicates that section 263, applicable to capitalization, is controlling over section 167 which allows the deduction of depreciation (Pet. Br. 17-18). Section 161 of the Internal Revenue Code in substance provides that the deductions allowed at sections 162 through 188 are to be allowed "subject to the exceptions provided" in sections 261 through 279.

Section 161 was made part of the Internal Revenue Code in 1954 and the committee reports indicate that it is merely

12. The Treasury Regulations further provide that the depreciation allowable on equipment used in self-construction of facilities, although it must be capitalized, may not be included in the basis of the facilities constructed in computing the investment credit. 26 C.F.R. 1.46-3(c)(1) and 1.48-1(b)(4). The investment credit is allowed on the equipment and not on the facilities constructed which would be the result reached if depreciation on the equipment used in construction were not required to be capitalized.

a housekeeping section. In both the reports of the Committee on Ways and Means and the Committee on Finance, it is provided that this section "states the general rule that in computing taxable income there shall be allowed the deductions specifically provided in the other sections of part VI relating to itemized deductions" and no mention is made of the exceptions in sections 261 through 279. H. Rep. No. 1337, 83d Cong., 2d Sess., A43; S. Rep. No. 1622, 83d Cong., 2d Sess., 195. The intention of Congress in adopting section 161 was neither to limit its intention concerning the scope of the deductions in sections 162 through 188 nor to expand its intention concerning the scope of the exceptions provided in sections 261 through 279. With respect to the issue in the instant case it is a question of whether Congress intended that the deduction for depreciation allowed at section 167 was to be limited by an exception set forth in section 263.

Section 263 has never been interpreted as superseding the deductions allowed under sections 162 through 188 so as to require the capitalization of such deductions in the absence of an indication in the legislative history of the Internal Revenue laws that section 263 so required. For example, as pointed out in this brief at pages 19-20, *supra*, section 263 has never been interpreted as requiring the capitalization of interest deductible under section 164, even though such interest was paid during construction and would not have been paid but for the existence of such construction. Such amounts could not be capitalized until the adoption of the statutory predecessors of section 266 and may be capitalized only if an election is made. Loss deductions under section 165 have never been treated as amounts to be capitalized. As pointed out in the government's brief, the Treasury Regulations have long provided that losses are not to be included in inventory, 26 C.F.R.

1.61-3(a) (Pet. Br. 18), and no effort has been made by the Treasury Department to require capitalization of losses as part of the adjusted basis of the facilities constructed regardless of the existence of section 263.

With respect to the question at issue, section 263 requiring capitalization does not provide for an exception to section 167 which allows the deduction for depreciation for the reason that Congress has not intended that there shall be an exception. As will be more fully discussed, section 263 which applies only to "amount[s] paid out" or "expenditures" was not intended by Congress to be an exception to the deduction for depreciation allowed by section 167.[13]

13. The government appears to assert as independent grounds for decision that the Internal Revenue Service has consistently treated depreciation on equipment used in self-construction of facilities as being the equivalent of cost or basis, and that courts with a special responsibility for interpreting federal tax laws have held that such depreciation should be capitalized.

The government has not consistently treated depreciation used in self-construction of facilities as being the equivalent of cost or basis. The statutory predecessors of sections 167 and 263 have been part of the income tax law since 1913. During the period 1927 through 1934 there was a series of court cases concerning the capitalization of depreciation in which it was held in the last case, *Great Northern Ry. Co.* v. *Commissioner*, 30 B.T.A. 691 (1934), that depreciation on construction equipment used in self-construction was not to be capitalized. Thereafter it was not until 1955 that the Internal Revenue Service first issued an opinion requiring capitalization, Revenue Ruling 55-252, 1955-1 C.B. 319. In 1958, the Treasury Department issued regulations under Code section 263. The basic regulation disallows deduction for "[a]ny amount paid out for new buildings or permanent improvements. . .", 26 C.F.R. 1.263(a)-1, issued as T.D. 6313, 1958-2 C.B. 114, and one example of capital expenditures included "[t]he cost of acquisition, construction or erection of buildings, machinery . . .", 26 C.F.R. 1.263(a)-2(a). This example does not state or imply that depreciation on equipment used in self-construction shall be capitalized. It is reasonable to infer that cost as used in the example refers merely to that which must be capitalized under section 263 of the Internal Revenue Code which does not include depreciation on equipment used in the self-construction of assets.

Further the Regulations have not been consistent. Under sections 46(a), 46(c) and 48(b) of the Internal Revenue Code the

As a second guide to the interpretation of the Internal Revenue Code, the government asserts that section 263 must be read expansively as the legislative expression of the principle of capitalization (Pet. Br. 21) and reliance is placed on *Commissioner* v. *Lincoln Savings and Loan Association*, 403 U.S. 345 (1971). The decision in this case does not sustain the government's assertion for it merely held that payments of additional premiums by the taxpayer savings and loan association to the Federal Savings and Loan Insurance Corporation were not deductible as ordinary and necessary expenses incurred for the carrying on of

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investment credit is allowed on the "basis" of property constructed. However, 26 C.F.R. 1.46-3(c)(1), 1.48-1(b)(4) and Revenue Ruling 69-228, 1969-1 C.B. 29, provide that the basis of self-constructed facilities shall not include depreciation on equipment used in construction for investment credit purposes.

With respect to the decisions by courts having special responsibility of interpreting and applying the tax laws, such decisions are neither uniform nor have they given proper consideration to the problem of analysis of the applicable provisions of the Internal Revenue Code. Many of these decisions made the fundamental error of accepting the proposition that anything which might appear to be part of the cost of the facilities constructed should be capitalized regardless of the provisions of the Internal Revenue Code. The first group of cases decided by the Board of Tax Appeals, and in one case affirmed, reached the conclusion that depreciation on equipment used in self-construction of facilities should be capitalized without adequate consideration. These cases include: *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225 (1927), A. and NA., VII-2 C.B. 16, 47 (1928), affirmed, 40 F.2d 372 (8th Cir., 1930), certiorari denied, 282 U.S. 855 (1930); *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 13 B.T.A. 988 (1928), reversed as to other issues, 47 F.2d 990 (7th Cir., 1931), certiorari denied, 284 U.S. 618 (1931); *Gulf, M. & N. R. Co.* v. *Commissioner*, 22 B.T.A. 233 (1931), NA. XI-2 C.B. 13 (1932), affirmed on other issues, 71 F.2d 953 (D.C. Cir., 1934), affirmed on other issues, 293 U.S. 295 (1934); *Missouri Pacific R. Co.* v. *Commissioner*, 22 B.T.A. 267 (1931), A. and NA. X-2 C.B. 48, 95 (1931). Thereafter the Board of Tax Appeals reversed its position and held that the depreciation on equipment used in self-construction should not be capitalized. *Great Northern Ry. Co.* v. *Commissioner*, 30 B.T.A. 691 (1934). Subsequently, the Tax Court of the United States decided *Brooks* v. *Commissioner*, 50 T.C. 927 (1968), reversed on other grounds, 424 F.2d 116 (5th Cir., 1970), and *Producers Chemical Co.* v. *Commissioner*, 50 T.C. 940

the taxpayer's trade or business under section 162(a). It was pointed out by this Court that the language used in section 162(a) and section 263 was not all inclusive (403 U.S. at 359). However, this is not to suggest that section 263 is a supervening provision of the Internal Revenue Code which is to be applied more expansively than was intended by Congress in adopting and amending it. It is well established that the provisions of the Internal Revenue Code should be interpreted to carry out the intention of Congress as indicated by the legislative history of such provisions. *Hanover Bank* v. *Commissioner*, 369 U.S. 672 (1962); *Commissioner* v. *Korell*, 339 U.S. 619 (1950); *Helvering* v. *Hammel*, 311 U.S. 504 (1941).

The issue in the present case differs from *Lincoln Savings and Loan* in that here the government asks this Court

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(1968), A. 1969-1 C.B. 21, in which depreciation was held to be one of the costs involved in rendering the service of producing oil which the taxpayer was required to produce without charge in partial payment for oil leases. Thereafter, the Tax Court decided *Coors* v. *Commissioner*, 60 T.C. 368 (1973), again without proper consideration of the applicable sections of the Internal Revenue Code. The decision cited by the government in which the most analysis was given to the issue is *Southern Natural Gas Co.* v. *United States*, 412 F.2d 1222 (Ct. Cl., 1969). In this case neither party took exception to the decision of the Trial Commissioner and his opinion was in substance adopted by the Court of Claims. It is submitted that it involves various errors of analysis, including such errors as defining the issue as one of carving out an exception for the deduction for depreciation (412 F.2d at 1265) where the issue in fact is whether Congress intended section 263 to be an exception to the deduction for depreciation allowed at section 167 without limitation for property used in business. A second error was the assumption that if the deduction for depreciation were allowed, the taxpayer would have a double recovery of cost, first when the depreciation was deducted and second when the self-constructed facility was sold (412 F.2d at 1265). Such a conclusion is clearly incorrect for if depreciation were deducted it would not be included in the basis of the facility constructed. A third error was the Trial Commissioner's inference that self-constructed facilities would have no basis (412 F.2d at 1266). This inference is unwarranted for such facilities would have a basis equal to the amounts expended for labor, materials, supplies and all other amounts paid out or expenditures which under section 263 of the Internal Revenue Code must be capitalized.

to ignore the words "amount paid out" and "expenditures" in section 263 to apply this section to depreciation of property which is neither. As hereinafter set forth the legislative history of section 263 indicates that Congress did not intend these terms, as used in this section, to include depreciation and uniformly throughout the Internal Revenue Code where Congress has intended the word "expenditures" to include depreciation in particular sections it has expressly so provided in each of such sections. There is no provision of this type in section 263 for the reason that capitalization of depreciation is contrary to the Congressional intention that depreciation is a means whereby a taxpayer may recover the capital cost of property over its own life. Under these circumstances the terms "amount paid out" and "expenditures" should be interpreted in accordance with their ordinary meaning. *Malat* v. *Riddell*, 383 U.S. 569 (1966); *Crane* v. *Commissioner*, 331 U.S. 1 (1947).[14]

14. The government suggests Congress has often manifested its awareness that construction related depreciation is non-deductible and gave as an example a quotation from the Report of the Committee on Finance concerning section 263(a)(1)(E), which excepts from capitalization the allowable deduction under section 182 for farmers' land-clearing expenses (Pet. Br. 18-19). It is submitted that the quotation from the Senate Finance Committee has been so edited as to be misleading insofar as it is relevant in the instant case. The full statement by the Senate Finance Committee is as follows:

> "Subsection (d) (2) of section 182 provides that expenditures to which section 182(a) applies shall include a reasonable allowance for depreciation with respect to property which is used in the clearing of land for the purpose of making such land suitable for use in farming *and which if used in a trade or business, would be property subject to the allowance for depreciation.* Under present law such depreciation must be capitalized." (S. Rep. No. 1881, 87th Cong., 2d Sess., 338) [Emphasis supplied]

From this full statement it is apparent that the Senate Finance Committee's view of depreciation as being nondeductible was based on the concept that the property used in the clearing of land was not used in a trade or business. To the extent there can be any doubt about this, such doubt is resolved by the following statement which appeared earlier in the Senate Finance Committee Report:

**A. The legislative history of section 263 indicates that depreciation is not intended by Congress to be treated as an amount paid out.**

Section 263 provides as follows:

> "(a) GENERAL RULE.—No deduction shall be allowed for—
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> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—. . . ."

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"This new provision deals with a problem quite similar to that which resulted in the enactment of the soil and water conservation provision. At the present time, expenditures made during the preparatory period in extending a farm may not be deducted since they are not expenses incurred in the business of farming." (S. Rep. No. 1881, 87th Cong., 2d Sess., 126)

From these statements it is clear that Congress felt that the depreciation was nondeductible because the property with respect to which the depreciation would be claimed was not used in a taxpayer's trade or business. As previously set forth, *supra*, pages 23-26, in the instant case the taxpayer's equipment, with respect to which depreciation is claimed, is used in its trade or business and the government has abandoned any argument with respect to this issue before this Court.

The government also cites the legislative history surrounding the enactment of section 263(a)(1)(B), excepting from capitalization the elective deduction allowed under section 174 for research and experimental expenditures, the predecessor of section 263(a)(1)(A), excepting from capitalization the elective deduction provided under section 616 for certain expenditures incurred in the development of mines, and sections 263(a)(1)(C) through (E) as suggesting a Congressional awareness that construction-related depreciation is not deductible. These exceptions are merely to conform section 263 with other provisions of the Code permitting an election to deduct, usually up to a maximum amount, or capitalize expenditures related to certain types of activities. The expenditures involved were of various types including labor, materials, etc. Where depreciation was involved in such other provisions of the Code, Congress found it necessary to define depreciation as an expenditure to include it in the sections providing elections. Congress has not found it necessary to provide an exception from section 263 for depreciation on equipment used in self-construction because the section does not by its terms and was not intended by Congress to require capitalization of depreciation. No occasion has been found when Congress considered such an unnecessary exception and in absence of consideration, it could not have been rejected by Congress. Compare Pet. Br. 19.

Thereafter there are listed various "expenditures" which are not to be capitalized equating the word "expenditures" with "amount[s] paid out".

The language still used by Congress to spell out the requirements for capitalization in the Internal Revenue Code was first used as part of an income tax statute in 1864. In a statute enacting a Civil War income tax, Act of 1864, ch. 173, 13 Stat. 223, Congress used language virtually identical to that in section 263 to deny deduction of certain amounts in computing income subject to tax. Section 117 of this Act provides as follows:

> ". . . but no deduction shall be made for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate. . . ." (13 Stat. 223, 282)

The Civil War statute did not allow a deduction for depreciation since depreciation had not yet been recognized for financial accounting or other purposes in the United States. *San Diego Land & Town Company* v. *Jasper*, 189 U.S. 439, 446 (1903); *Eyster* v. *Centennial Board of Finance*, 94 U.S. 500, 503 (1877); *cf. United Railways & Electric Company of Baltimore* v. *West*, 280 U.S. 234, 265 (1930) (dissenting opinion). Therefore, this language when first used was not intended by Congress to deny or limit a deduction for depreciation.

In 1909 when Congress first adopted a tax statute that could be considered a direct predecessor of the present Internal Revenue Code, the Tariff Act of 1909, ch. 6, 36 Stat. 11, it did not include a provision requiring capitalization, even though capitalization of the amounts expended to acquire capital assets was necessarily to be inferred, but it did include a provision which would indicate that its concept of depreciation was not that of an amount paid out which could be required to be capitalized. At

section 38, Second, there was allowed a deduction from gross income for ". . . all losses actually sustained within the year . . . including a reasonable allowance for depreciation of property, if any. . . ." 36 Stat. 11, 113. In equating depreciation with losses, Congress manifested an understanding of depreciation as being a deduction of a type that could not be capitalized. Up to the present time, there has been no effort on the part of the Treasury Department to capitalize losses as part of the cost of an asset, and without reliance on any particular provision of the Code, they are expressly excluded from cost under the Regulations concerning inventories. 26 C.F.R. 1.61-3(a).

When the Tariff Act of 1913, ch. 16, 38 Stat. 114, was adopted, Congress at section II B, with respect to individuals, provided that "no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate". 38 Stat. 114, 167. There was no similar requirement for capitalization in the case of corporations. Congress continued to manifest an understanding that depreciation was similar to a loss by combining these two deductions with respect to corporations at section II G(b) although they were separate with respect to individuals. 38 Stat. 114, 172.

In the Revenue Act of 1916, ch. 463, 39 Stat. 756, at section 12(a) Second, Congress first explicitly imposed the requirement for capitalization on corporations by providing "[t]hat no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments" and continued to manifest its understanding that depreciation and losses were to be equated by combining both deductions at section 12(a) Second, which allowed a deduction for "[a]ll losses actually sustained and charged off within the year . . . including a reasonable allowance for

the exhaustion, wear and tear of property." 39 Stat., 756, 768.

Thereafter in 1918 rearrangements were made of the locations of the deduction for depreciation and of the requirement for capitalization. Other than the addition of the word "expenditures" as being the equivalent of "amount[s] paid out" in the Revenue Act of 1951, section 309, ch. 521, 65 Stat. 452, 487, the language providing for capitalization has been continued without substantial change.

When Congress first adopted the requirement of capitalization in the statutory predecessors of section 263, it clearly intended that capitalization should be applicable only to amounts paid out and that depreciation was not in the nature of an amount paid out. Rather, depreciation was regarded as similar to a loss of property or a decrease in value of property. See and compare: *Fribourg Navigation Company, Inc.* v. *Commissioner*, 383 U.S. 272, 276 (1966); *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960); *United States* v. *Ludey*, 274 U.S. 295, 300 (1927).[15]

The same concept is expressed in the Regulations at 26 C.F.R. 1.167(a)-1 which provides in part:

15. For similar indications of the nature of depreciation outside of the field of taxation, see *Lindheimer* v. *Illinois Bell Telephone Company*, 292 U.S. 151, 167 (1934); *Knoxville* v. *Knoxville Water Company*, 212 U.S. 1, 13 (1909); *Colorado Interstate Gas Co.* v. *F.P.C.*, 142 F.2d 943, 959 (10th Cir., 1944), affirmed and reversed on other issues, 324 U.S. 581, 626 (1945).

A similar understanding was expressed in a report of a Subcommittee of the Committee on Ways and Means in 1933 in the following statement:

> "In the first place, it must be remembered that these amounts [depreciation and depletion] deducted from income do not represent cash outgo like wages, repairs, and similar expenses, but are annual reserves generally theoretically set aside to replace plant and property investments. . . ." (Report of Subcommittee of the Committee on Ways and Means, H. Rep. December 4, 1933, 73d Cong., 2d Sess., 4)

> ". . . The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amount set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and §1.167(g)-1. . . ."

The intention of Congress that section 263, which is applicable only to an amount paid out and does not provide an exception from the deduction for depreciation, as indicated by the early legislative history of sections 263 and 167, is consistent with the subsequent emphasis placed by Congress on the deduction for depreciation as a means of tax-free recovery of cost in its amendments at the time of the adoption of the Internal Revenue Code of 1954 and thereafter. As previously pointed out in this brief at pages 12-13, *supra*, Congress, recognizing the need for taxpayers to recoup the cost of their capital assets in order that they may be replaced at the end of their useful lives with efficient and probably higher cost assets and in order that taxpayers will have available funds to modernize equipment to meet competition from abroad, adopted accelerated methods of depreciation such as the declining balance method and the sum of the years-digits method. The declining balance method permits the deduction of approximately forty percent of the cost of an asset in the first quarter of its service life and two-thirds of the cost in the first half of its life. H. Rep. No. 1337, 83d Cong., 2d Sess., 23. As further pointed out in this brief at pages 13-14, *supra*, in 1971 the ability of taxpayers to recover their capital investment in the early portion of the lives of their assets was increased by legislation permitting the use of lives in the 30th percentile of the lives previously used by taxpayers and further allowing such lives to be reduced by 20 percent. The end result of

these provisions is to permit as large as a 50 percent deduction of the cost of equipment in the first partial year of its useful life.[16] This emphasis by Congress on allowing accelerated tax-free recovery of the capital cost of equipment to provide taxpayers with funds for replacement and modernization is incompatible with the intention the government attributes to Congress of requiring the capitalization of depreciation on equipment used by the taxpayer in self-construction and thereby deferring recovery of cost until long after the termination of the life of the asset.

It is apparent that in adopting these provisions Congress has continued its objective of treating depreciation as a means of tax-free recoupment of the cost of capital assets rather than as a means of matching the deduction for depreciation against the production of income as urged by the government (Pet. Br. 9). Such a theory of matching depreciation against income is the only possible justification for the deferral of depreciation urged by the govern-

16. In its administration of the deduction for depreciation the Department of the Treasury has increasingly recognized the Congressional intent to emphasize recovery of cost. On January 11, 1971, the Treasury Department issued a statement in which it described the Asset Depreciation Range System pursuant to which taxpayers were to be permitted to elect to compute depreciation. In an example set forth in this statement, there is discussed the depreciation to be allowed on lathes acquired on June 15, 1971 for $10,000 and a drill press acquired on October 1, 1971 for $5,000, the total cost being $15,000. The anticipated lives of these items of equipment are five years. Depreciation is to be taken on the double declining balance method. The depreciation to be allowed in the year 1971 is $6,250 computed in the following manner. Under the Asset Depreciation Range System, the taxpayer will be permitted to depreciate the property over a period of four years and to obtain a full year's depreciation on the lathes which were placed in service before July 1, 1971 and one-half year's depreciation on the drill press which was placed in service after that date. Applying the double declining balance method on a four year life, the taxpayer will be able to deduct $5,000 depreciation for the lathes and $1,250 for the drill press. (Treasury Statement of January 11, 1971 as reported in Standard Federal Tax Reports, Commerce Clearing House, 1971 Volume 7, ¶6366 at page 71,130)

ment in the instant case, a theory which has never been part of the income tax law. *Virginian Hotel Corporation* v. *Helvering*, 319 U.S. 523 (1943).

As previously pointed out in this brief, at pages 9 and 16, *supra*, equipment used by a taxpayer in the self-construction of its facilities represents a capital investment which like all other capital investments must be recouped if the equipment is to be replaced with modern equipment at the end of its useful life. The taxpayer has the same need to obtain more modern equipment for use in the construction of its own facilities as it has to replace and modernize like equipment used in maintenance or operations or as a contractor would have if he constructed the facilities for taxpayer. The investment for equipment used in self-constructed facilities differs from such expenditures as direct labor and materials, the cost of which need not be fully recovered until the constructed facilities must be replaced. The clear intention of Congress evidenced in the legislative history of section 263 that depreciation is not an amount paid out for which capitalization is required under this section is applicable to all depreciation including depreciation on equipment used by a taxpayer in the self-construction of facilities.

**B. Where Congress has intended to treat depreciation as an amount paid or an expenditure it has uniformly so provided in the Internal Revenue Code indicating its understanding that in the absence of such a provision depreciation was not intended to be included in such terms.**

Congress has in certain sections of the Internal Revenue Code provided that a taxpayer may elect to treat specific types of expenditures either as an expense, often subject to limitations, or as capital. These sections cover a broad scope of expenditures including labor, material and supplies and similar expenditures. However, where Congress has

in these sections intended that depreciation shall also be treated as an expenditure to be either deducted, ordinarily up to a maximum amount, or capitalized, Congress has expressly included a provision to this effect in the sections. Clearly Congress understood that it was necessary to provide that depreciation was an expenditure in order to treat it as such in these sections for it did not provide a special definition of the other items involved.

In other sections of the Internal Revenue Code Congress has permitted deduction of an amount paid or of which payment is made and has not expressly provided that depreciation is to be treated as an amount paid or an expenditure. In these sections depreciation is not treated as an expenditure.

Consistently throughout the Internal Revenue Code, wherever Congress has intended that depreciation should be treated as an expenditure it has expressly so provided. The sections of the Internal Revenue Code in which an election to treat expenditures as an expense or as an amount to be capitalized include the following. At section 174 a taxpayer may elect to treat research and development expenditures as expenses or to capitalize such expenditures as deferred expenses amortizable over a period of not less than 60 months. At section 182 a taxpayer engaged in the business of farming may elect to treat expenditures for clearing of land as an expense subject to limitation on the maximum amount and if no election is made or if the expenditures exceed the maximum they are to be capitalized. In section 615 a taxpayer may treat pre-1970 exploration expenditures as an expense subject to a maximum limitation, but if the expenditures exceed the maximum or if an election is made the expenditures are to be capitalized and amortized on a ratable basis as ores are produced. In section 616 a taxpayer is permitted to deduct mine development expenditures or to elect to capitalize such expenditures and deduct them on a ratable basis as ores are

produced. In section 617 a taxpayer is permitted to elect to deduct exploration expenditures to locate and ascertain the quality of deposits of ores or minerals subject to a maximum limitation but in the absence of such election or if the expenditures exceed the maximum amount, they are to be capitalized.

These sections were enacted to provide for elective treatment of expenditures in situations in which there had previously been doubt as to whether the expenditures were to be deducted or capitalized;[17] the expenditures may have been incurred prior to the time a taxpayer was considered to be engaged in a trade or business and therefore nondeductible;[18] or it was the position of the Internal Revenue Service that the expenditures should be capitalized.[19]

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17. For example in the case of research and experimental expenditures there was uncertainty in the law concerning deduction or capitalization. H. Rep. No. 1337, 83d Cong., 2d Sess., 28; S. Rep. No. 1635, 83d Cong., 2d Sess., 33.

18. As previously set forth at pages 31-32, *supra*, Congress stated that expenditures by farmers for clearing land could not be deducted because they were preparatory to farming and not incurred in the business of farming.

19. With respect to expenditures for discovery or exploration of minerals, after the enactment of section 23 (ff) of the Internal Revenue Code of 1939, in the Revenue Act of 1951, section 342, ch. 521, 65 Stat. 452, 515, which first provided the taxpayer with an option to deduct or capitalize exploration expenditures (in this case up to a maximum of $75,000), the Internal Revenue Service was of the view that depreciation on equipment used in exploration by a taxpayer engaged in the trade or business would be deductible in full in absence of a specific provision in section 23 (ff) treating depreciation as an expenditure. In Treasury Regulations 118 at section 39.23 (ff)-1(c) the following statement was made:

> "The deduction described in paragraph (a) of this section is allowable only for the amount of all such expenditures paid or incurred by the taxpayer in the taxable year as does not exceed $75,000. Amounts otherwise allowable as deductions without reference to this section (except allowances for depre-

In each of the sections of the Internal Revenue Code in which Congress provided an option to deduct or capitalize the expenditures, Congress found it necessary to provide specifically that depreciation would be treated as an expenditure to make it clear that it would be treated as such. For example, at section 615(a) it is provided:

> "This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures paid or incurred. . . ."

A statement to the same effect is made in each of the sections providing for an election.

However, in the case of section 263, Congress has never provided that depreciation shall be considered as an amount paid out or an expenditure. In light of the care Congress has taken throughout the Internal Revenue Code to define or designate depreciation as an expenditure when it is intended to be treated as such, it is apparent that Congress has continued the intention of previous Congresses which first enacted the statutory predecessors of section 263 that depreciation should not be considered as an amount paid out or an expenditure under this section.

On the other hand where Congress has not intended the terms "payment" or "amount . . . paid" to include depreciation, it has not included in the applicable section of the Internal Revenue Code a provision that defines depreciation as being within the scope of these terms. Two exam-

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ciation) are not to be taken into account in determining this limitation."

Compare *New Quincy Mining Company* v. *Commissioner*, 36 B.T.A. 376 (1937), in which it was held that depreciation incurred in development of a mine was not deductible where the taxpayer had not yet engaged in business.

ples appear at section 170(a)(1), where a deduction is allowed for ". . . any charitable contribution . . . payment of which is made within the taxable year . . .", and section 213(a) in which there is allowed a deduction for medical and dental expenses equal to ". . . the amount by which the amount of the expenses paid during the taxable year . . . exceeds 3 percent of the adjusted gross income . . . ."

It has been regularly held that automobile expenses incurred for charitable or medical purposes, such as those incurred for gas, oil and automobile taxes, would qualify for the charitable and medical expense deductions. However, in the decisions allowing such expenses as a deduction, it has been uniformly held that depreciation is not an amount, payment of which was made, which would qualify as a charitable contribution or an amount paid which would qualify as a medical or dental expense. *Orr* v. *United States*, 343 F.2d 553 (5th Cir., 1965); *Mitchell* v. *Commissioner*, 42 T.C. 953 (1964), A. 1965-2 C.B. 6; *Gordon* v. *Commissioner*, 37 T.C. 986 (1962); *Calafut* v. *Commissioner*, 23 T.C.M. 1431 (1964).[20] The reasoning of the courts was clearly that depreciation was not an amount paid. As the court stated in *Orr* v. *United States, supra:*

> "It is entirely possible, as the taxpayer suggests, that Congress and its Committees were not thinking of depreciation when they used the word 'payment'. The absence of any evidence as to whether Congress focused on this problem provides no basis for extend-

20. Under the Internal Revenue Code of 1939 the same conclusion has been reached, depreciation is not amount paid. At section 201(c)(7)(B) of the Internal Revenue Code of 1939 insurance companies were allowed a deduction for ". . . investment expenses paid during the taxable year". In *State Mutual Life Assurance Company of Worcester* v. *Commissioner*, 246 F.2d 319 (1st Cir., 1957), the court alternatively held that depreciation could not be deducted in any event as an investment expense under section 201(c)(7)(B) on the ground that depreciation is not an expense paid.

ing the meaning of payment to include 'depreciation'. A depreciation expense is an indispensable element in accounting. But it is not a 'payment', not a transfer of money or property. We are bound by plain, prosaic language of the statute. . . ." [Footnote omitted] (343 F.2d 553, 556)

In *Gordon* v. *Commissioner, supra,* the Tax Court made the following statement:

". . . The statute permits the deduction for 'expenses paid' and 'amounts paid' and respondent correctly interprets the statute as permitting deduction for 'medical expenses actually paid.' Sec. 1.213-1(a), Income Tax Regs. Depreciation is a 'decrease in value.' *Massey Motors Inc.* v. *United States,* 364 U.S. 92, 96. Any allowance for depreciation is not an 'expense paid' or 'amount paid.'" (37 T.C. 986, 987)

Sections 170 and 213 are applicable both to cash basis and accrual basis taxpayers. It is not a grounds for distinction that sections 170 and 213 could be considered as concerning only cash basis taxpayers.

It would appear that in adopting the language of both sections 170 and 213 Congress intended that the deduction for charitable contributions and medical expenses was to be limited to amounts paid for these purposes. In these sections Congress had no intention to extend the deductions to amounts which were not paid and therefore did not include in them a definition of paid or payment which would include depreciation. It is a further illustration in the Internal Revenue Code of the fact that when Congress intended depreciation to be considered an amount paid or the equivalent thereof it specifically so provided.

However, the government argues implicitly that although the terms "payment" or "amount . . . paid" may properly

include depreciation as an item paid when their equivalent is used in section 263, they do not include depreciation in section 170 or section 213 for the reason that section 170 requires payment "within the taxable year" and section 263 requires that the amount be paid "during the taxable year" (Pet. Br. 24). The government necessarily argues that the words "amount paid" in section 263 do include depreciation on the theory that payment is not expressly required under section 263 *in the taxable year*. The government suggests that for section 263 but not for sections 170 or 213 it is sufficient that the amount be paid at some time such as when the assets involved were purchased (Pet. Br. 23).[21]

The distinction urged by the government between sections 170, 213 and 263 does not exist. If depreciation is an amount paid under section 263 it must be paid during the taxable year. Clearly the depreciation the government urges must be capitalized under section 263 is the amount which must be considered paid during the taxable year in which equipment is used in self-construction in order to disallow the deduction under this section. It is only the depreciation on the equipment used in construction during the year in which it is so used that the government would capitalize. As a specific example, if one of taxpayer's trucks was used in part to construct facilities during the year 1962, it is the portion of the depreciation on that truck during the period it was used for construction in 1962 that the government would disallow and capitalize as part of the basis of the facility constructed. If the truck were used in part in construction of a single facility begun in 1962 and

21. This suggestion if applied to section 263 would equally indicate a "capricious" intention on the part of Congress as it would if applied to indicate that Congress intended a deduction for depreciation under sections 170 and 213 in the year an automobile was purchased (Pet. Br. 24, n 9). Under all three sections it is the depreciation for the taxable year which must come within the scope of "amount paid out" (section 263), "payment" (section 170) or "amount . . . paid" (section 213).

completed in 1963, for the year 1962 the government would disallow the depreciation and capitalize it as part of the basis of construction in progress and for the year 1963 the government would disallow depreciation on the truck and include it, as well as depreciation for the year 1962, in the basis of the completed facility. Depreciation must be considered an amount paid on an annual basis if it is to be treated as an amount paid under section 263 to the same extent that it would have to be considered an amount paid on an annual basis if it is to be deducted under sections 170 and 213.[22]

It is not the requirement for annual determinations that prevents depreciation from being treated as a payment under section 170 or an amount paid under section 213. Instead it is the fact that Congress does not intend by use of these terms in sections of the Code to include depreciation in the absence of a specific provision so indicating and Congress did not include provisions to this effect in sections 170 and 213.

The legislative history of section 167 allowing depreciation and section 263 concerning capitalization indicates that when Congress adopted these provisions it did not intend that section 263, which provides for the capitalization of amounts paid out, later extended to include expenditures as an equivalent term, should require the capitalization of depreciation. The intention of Congress to permit the deduction of depreciation without limitation is consis-

22. Had Congress intended to include depreciation within the meaning of payment in section 170 and amount paid in section 213, it could have defined these terms to include depreciation as it has in other sections of the Code. The sections could then be administered by requiring proof of the amount of the depreciation or by including it in the arbitrary allowance for automobile expenses under such sections. Revenue Procedure 70-24, 1970-2 C.B. 505, allows a deduction of six cents per mile for automobile expenses as charitable contributions and medical expenses which does not include any allowance for depreciation.

tent with the continued emphasis placed by Congress on permitting taxpayers to recover the capital costs of assets over their useful lives, and presently in the early portion of such lives, in order that taxpayers will have funds to replace the assets ordinarily with more costly modern equipment. The understanding of Congress that an amount paid or an expenditure, as used in section 263, does not include depreciation is further indicated by the care taken by Congress throughout the Internal Revenue Code to define those terms as including depreciation in any section in which it intended to treat depreciation as such and not to include such a definition in any section where it was not so intended. In section 263, Congress has not defined amount paid or expenditure as including depreciation thereby indicating its continued intention that this section should not limit, or provide an exception to, the deduction for depreciation.

It is not to be inferred that this is a matter of inadvertence. It is equally important for a taxpayer who uses equipment in self-construction to be permitted tax-free recovery of the cost of such equipment over its life in order that it may be replaced and modernized as it is for taxpayers who recover cost by depreciation on equipment used for other purposes.

In light of the intention of Congress that amount paid and expenditures in section 263 should not include depreciation which is a reduction in value of property as it is used, these terms should be interpreted in accordance with their ordinary meaning. *Malat* v. *Riddell*, 383 U.S. 569 (1966); *Crane* v. *Commissioner*, 331 U.S. 1 (1947). Section 263 should be construed to carry out the intention of Congress that it is not an exception to or a limitation on the deduction for depreciation allowed in section 167. *Hanover Bank* v. *Commissioner*, 369 U.S. 672 (1962); *Commissioner* v. *Korell*, 339 U.S. 619 (1950); *Helvering* v. *Hammel*, 311 U.S. 504 (1941).

The government's assertion that depreciation on equipment used in self-construction should be capitalized in order to match the deduction for depreciation against generation of income in accordance with financial accounting principles is contrary to the tax accounting required by the principles of depreciation adopted by Congress in allowing the tax-free recovery of the cost of a capital asset over the early portion of its life. Matching of the deduction for depreciation against income has never been a requirement or principle of tax law, *Virginian Hotel Corporation* v. *Helvering*, 319 U.S. 523 (1943), and capitalization of depreciation to achieve such a result should not be required where it would conflict with the provisions of sections 167 and 263 and the principles of tax accounting for depreciation. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963).

## Conclusion

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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